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MEMORANDUM NOTE DE SERVICE

Security classification / Classification de sécurité: PROTECTED B

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Our file / Notre référence:

Your file / Votre référence: 2018FIN471254

Date: APR 06 2018

Memo to the Minister or Minister's Staff

Min's Office............Orig. + 5
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TO / À: Minister of Finance

FROM / DE: Paul Rochon

SUBJECT / OBJET: **Explaining the Drivers of the U.S. Dollar Depreciation**

For information only.

Overview

Over the past 15 months, the U.S. dollar has depreciated by 7.3 per cent against a trade-weighted basket of currencies despite a surging stock market, robust economic growth and four interest rate hikes by the Federal Reserve. This development has surprised some market analysts who generally expected the U.S. dollar to appreciate in 2017. This note highlights potential reasons for this depreciation.

First, the recent depreciation follows a 30 per cent appreciation of the U.S. dollar between 2013 and 2016, and unwound less than one-third of the prior gain. Beyond the significant earlier run-up, economic fundamentals largely explain the recent weakening of the U.S. dollar:

- There are likely better investment opportunities emerging outside the U.S. as illustrated by the fact that U.S. economic activity, while strong in 2017, was somewhat weaker than that of its trading partners in aggregate. This is also illustrated by already very high valuations in U.S. equity markets;
- The interest rate gap of the U.S. over Europe, United Kingdom, Japan and Canada declined in the first nine months of 2017. Over the medium term, the gap is also expected to decline – the normalization process of the Federal Reserve has been very well telegraphed, and largely already "priced in" by markets, while among advanced economies' this is less clearly the case; and,
- The U.S. trade balance and budgetary deficits deteriorated in 2017. Reflecting U.S. Administration policies, both expected to continue to deteriorate in the near future.

In addition, in April 2017 and again in January 2018, the U.S. Administration openly complained that the value of the U.S. dollar was too high, which put further downward pressure on the greenback. Some analysts have also suggested that the difficulty the U.S. Administration is having in implementing its election promises, and an overall level of political uncertainty ahead of the November 2018 mid-term Congressional elections, have contributed to the weakening the U.S. dollar.

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Looking forward, some factors will continue push the U.S. dollar higher against other currencies (fiscal stimulus and monetary policy tightening), while those factors that have contributed to the U.S. dollar depreciation in 2017 (stronger growth outside the U.S., rising trade and budget deficits) will also continue. [redacted]

Background

Between January 2013 and December 2016, the U.S. dollar appreciated by about 30 per cent against a basket of foreign currencies.[1] Since the beginning of 2017, the U.S. dollar has depreciated by 7.3 per cent, with about 1.3 percentage points of this depreciation occurring during the first quarter of 2018. [redacted]

[redacted]

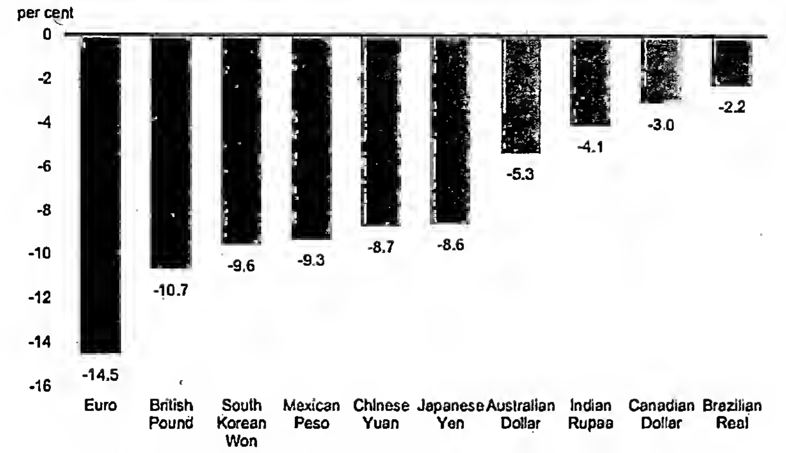
The weakening of the dollar was relatively broad-based against individual currencies. The U.S. dollar lost 14.5 per cent of its value against the euro since December 2016, the largest bilateral decline among its main trading partners (Figure 2). In contrast, it has fallen by only 3 per cent versus the Canadian dollar.

[1] Using monthly data.

s.20(1)(b)

s.21(1)(a)

Figure 2: Variation of the U.S. Dollar against other Currencies between December 2016 and March 2018

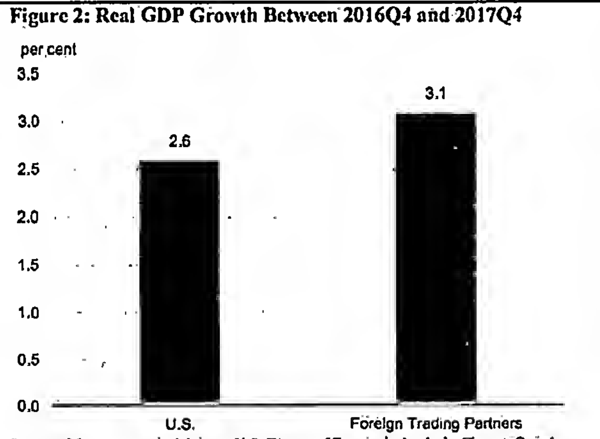


Sources: Federal Reserve Board; Finance Canada calculations

The recent depreciation of the U.S. dollar likely reflects a combination of factors:

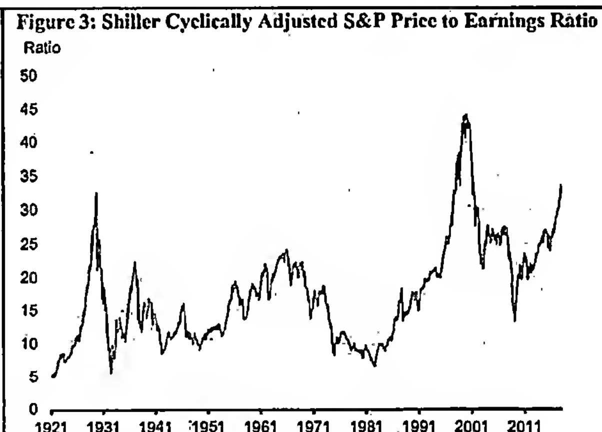
1) **Better investing opportunities elsewhere.** Economic activity among foreign trading partners (in aggregate) outpaced that of the U.S. Between 2016Q4 and 2017Q4, the U.S economy grew by 2.6 per cent while that of its trading partners increased 3.1 per cent (Figure 2). Moreover, U.S. equity valuations are highly elevated, even after the February correction, with the cyclically adjusted price to earnings ratio (CAPE), at levels unseen since the 2000-2001 dotcom bubble (Figure 3). This economic growth differential and rich stock market valuation suggest that there are possibly better investing opportunities outside the U.S., which would attract capital and lead to an overall strengthening of those currencies vis-à-vis the U.S. dollar.

Figure 2: Real GDP Growth Between 2016Q4 and 2017Q4



Sources: Macroeconomic Advisers; U.S. Bureau of Economic Analysis; Finance Canada calculations

Figure 3: Shiller Cyclically Adjusted S&P Price to Earnings Ratio



Sources: Robert Shiller; Haver Analytics

2) **Less favorable interest rate differential.** The interest rate gap of the U.S. over Europe, United Kingdom, Japan and Canada declined in the first nine months of 2017, likely driven by waning U.S. core inflation and the anticipation that the Fed would ease up on its tightening cycle. Looking forward, the Federal Reserve is the most advanced in its monetary policy normalization process (i.e., reduction of the size of its balance sheet, while raising its policy rate) among its peers. The Fed's forward policy guidance is clear and markets have

likely largely 'priced in' the future path of U.S. monetary policy, in contrast with the expected future path of monetary policy of other major central banks, which is more uncertain. Therefore, markets likely expect interest rates will rise at a faster pace overseas making expected returns higher for investment made outside the U.S. Put another way, with the Federal Reserve already two years into a rate hiking cycle, there is now likely less upside from investments in U.S. dollar.

3) [redacted] Both the President[2] and Treasury Secretary Mnuchin[3] have publically expressed concerns over a "strong dollar" while signalling that the Administration prefers "low interest rates". This has also put downward pressure, albeit likely temporary, on the currency.

4) **Deteriorating trade balance.** Finally, between 2016Q4 and 2017Q4, the U.S. current account balance deteriorated by more than 12 per cent, as the growth in imports outpaced that of exports (Figure 4). This led to increased demand for foreign currencies relative to the U.S. dollar. The U.S. current account is expected to deteriorate further over the short-to medium-term in part reflecting the impact of the Administration's fiscal stimulus (i.e., tax cuts and increased spending) at a time when the economy is at full capacity, which will boost import demand. The increasing current account and budgetary deficits (i.e., the twin deficits) are expected to continue to weigh on the U.S. dollar.

Figure 5: U.S. Current Account Balance

Note: Last data point is 2017Q4.
Source: U.S. Bureau of Economic Analysis

Looking forward, the expected trajectory of the U.S. dollar against a trade-weighted basket of currencies is less clear, as it is subject to offsetting forces. There are a number of factors that should push up the U.S. dollar against most other currencies: a pick up in inflation and long-term interest rates; tax cuts that are expected to boost growth in the short-term; and, the continuation of interest rate hikes by the Federal Reserve (which may be accelerated to the

2 *"Donald Trump's admission that he thinks the U.S. dollar is getting too strong and that he favors low interest rates sent the greenback and yields on U.S. government bonds down sharply."* (USA Today, Apr. 12, 2017)

3 *"Obviously a weaker dollar is good for us as it relates to trade and opportunities."* (CNBC, Jan. 24, 2018)

s.21(1)(a)

extent that cutting taxes when the economy is already operating at potential will simply bid up prices rather than generating increased real activity). However, the factors that have contributed to the dollar's recent weakening are expected to remain in 2018, notably the widening U.S. current account deficit, declining interest rate differential (notably with Europe as the European Central Bank continues to taper its asset-purchasing program) and more broadly, the reduced attractiveness of U.S. assets for international investors.

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File no. No de dossier	Date
2018FIN471254	APR 05 2018

Associate Deputy Minister & G7 Deputy for Canada **Sous-ministre délégué et représentant du Canada au G7**	**(Sign on behalf of DM)** **(Signer au nom du SM)**	☐
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